

Index

abnormal earnings growth (AEG), 58–59, 61, 63
Abnormal Earnings Growth (AEG) model, 59, 61, 222n12
accounting: anchoring and, 35–43; defined, 33; good, 194–98; growth generated by, 115–26; profitability generated by, 105–14; standardization in, 234nn7, 8; uncertainty and, 65; valuation and, 1–3, 7, 62
accounting arbitrage, 190–92
accounting modeling of risk, 140–45
Accounting Principle 1, 39–40, 164, 168
Accounting Principle 2, 48, 164
Accounting Principle 3a, 90–91, 158, 164
Accounting Principle 3b, 91, 164
Accounting Principle 4, 110–11, 164
Accounting Principle 5, 118, 164
Accounting Principle 6, 156–57, 164
Accounting Principle 7, 164, 180
accrual accounting, 43, 46–50, 63, 209, 218n9
accrual anomaly, 192
AEG (abnormal earnings growth), 58–59, 61, 63
AEG (Abnormal Earnings Growth) model, 59, 61, 222n12
AIG (American International Group), 30, 139, 142
American International Group (AIG). *See* AIG (American International Group)
amortized historical cost, 173
anchoring: accounting and, 35–43; accrual accounting and, 46–50; adding speculation to book value and, 50–57; cash accounting and, 43–46; conclusions on, 61–63; on earnings, 57–62; on fair value accounting, 169–74
Apple, 107, 203
APT (arbitrage pricing theory), 26, 212n7
arbitrage: accounting, 190–92; limits to, 212n7
arbitrage pricing theory (APT), 26, 212n7
asset pricing models, 24–27, 31–32, 94, 131, 139. *See also* Capital Asset Pricing Model (CAPM)

assets: intangible assets, 111, 179–81, 183; return on assets, 224n10; unlevering accounting and, 95–96. *See also* operating assets

assumed distribution, 138–39

balance sheet, 186–88, 196–97, 199–202, 235n14

balance sheet leverage, 91, 97

banking crisis (2008), 174

below the line disclosures, 198

benchmarks, for growth, 72–80, 81, 136, 210

beta: book-to-price and, 150; in Capital Asset Pricing Model, 130, 216n34; “cash flow betas,” 228n13; cost-of-capital and, 226n1; estimating, 140; risk and, 7–8; Warren Buffett on, 212n6

beta bashing, 7–8

bleeding back income, 204–6

book leverage. *See* balance sheet leverage

book rate-of-return on common equity (ROCE): adding speculation to book value and, 50–55; calculating, 218n10; defined, 164; leverage and, 90, 97–99; profitability generated by accounting and, 109–12; valuation and, 42–43, 159

book-to-price (B/P) ratio, 26–27, 33, 94, 150–62

book value: adding speculation to, 50–57; intelligent investing and, 209. *See also* future book value

borrowing, 20–21, 31, 90–94, 215n25, 232n18

Bourne, J. H., 219n11

B/P (book-to-price) ratio. *See* book-to-price (B/P) ratio

brand-building, 110–11

bubbles, 14–15, 23, 95, 102, 113–14, 169–71

Buffett, Warren, 28, 49, 51, 171, 212n6, 215n22

businesses, fundamental principles on, 6–7

Capital Asset Pricing Model (CAPM), 24–26, 129–31

CAPM (Capital Asset Pricing Model), 24–26, 129–31

cash accounting, 43–46, 63, 124, 209

“cash flow betas,” 228n13

cash flows, 17, 37–38, 173. *See also* free cash flows (FCF)

CFA Institute, 233n22

change in residual earnings, 58–59

Church of England, 21–22

Cisco Systems, 66–80, 109, 111, 132–37, 170, 175

Citigroup Inc., 86, 87

“clean surplus” equation, 39

Coca-Cola Company, 110–11

comparable multiples, 23

competitive advantage, 70–71, 76, 79–80, 111–12

complexity, 206–7

Conceptual Framework, 166, 173, 186, 194, 235n13

conservatism, 158, 197, 200, 205–6, 210, 235n13

conservative accounting, 114–19, 123–27, 156–58, 164, 209

continuing value, 44, 46

cookie jar accounting, 109–10, 204. *See also* deferred revenues

cost-of-capital: Capital Asset Pricing Model and, 129–31; determining, 25, 226n1; finessing, 131–38; intelligent investing and, 209; introduction to, 128–29

DCF (discounted cash flow) analysis, 43–47
 debt, 178, 215n25, 232n18. *See also* borrowing
 declining growth benchmark, 75–77
 deferred revenues, 107, 109–10, 203, 204
 Dell Computer, 183–86
 depreciation, 49–50
 disclosures, below-the-line, 198
 discounted cash flow (DCF) analysis, 43–48, 54, 218n11
 discount rate: asset pricing and, 25, 31; estimating, 36; in valuation formulas, 128–29
 discretionary conservatism, 205–6
 discretionary earnings smoothing, 206
 distribution, 32–33, 138–39, 143, 178–79
 diversification, 19–20, 24, 158, 216n32
 dividend discount model, 17, 31, 51, 214n16, 217n2, 218n11
 dividend displacement property, 18
 dividend irrelevance, 18–19, 38, 40–41, 51, 219n12
 dividends: liquidity and, 214n19; reinvesting, 59
 Dodd, David L., 51, 64–65, 221n1
 earnings: in accrual accounting, 47–48; anchoring on, 57–62; fair value accounting and, 187; smoothing, 206
 earnings growth, 84, 88–95. *See also* abnormal earnings growth (AEG)
 earnings per share (EPS), 49, 52–53, 88, 99, 210
 earnings-to-price (E/P) ratio, 78–80, 149–62, 210
 economic profit, 111–12, 218n10
 economic rate-of-return, 111
 efficient market theory, 3–5, 14–17, 22, 170–72, 213nn12, 13
 employee stock options, 199–200, 235n10
 Enron, 173–74, 201, 207
 enterprise rate-of-return. *See* return on net operating assets (RNOA)
 E/P (earnings-to-price) ratio. *See* earnings-to-price (E/P) ratio
 equity valuation, 98–99, 199–200, 219n11
 excessive conservatism, 205–6
 executive compensation, 93
 exit price, 169, 176
 fair market price, 169–70, 186
 fair value accounting: as anchor, 169–74; bank loans and, 232n14; CFA Institute and, 233n22; conclusions on, 186–88; focus on transactions and, 201; free markets and, 179; good accounting and, 194–95, 196; historical cost accounting and, 168–69, 179–86; intelligent investing and, 210; market prices and, 232n17; one-to-one principle and, 174–77; overview of, 166–67; risk and, 177–79
 Fama, Eugene, 4
 Fama and French asset pricing model, 26–27, 129, 150–51, 216n34
 Farrell, Shaun, 21–22
 FASB (Financial Accounting Standards Board). *See* Financial Accounting Standards Board (FASB)
 fat-tail return distributions, 30, 138–39, 228n10
 Fed model, 78–79, 163, 222n12

Financial Accounting Standards Board (FASB), 166–67, 169, 177, 194, 234nn7, 8, 235n10

financial engineering, 28–31, 139

financial supermarkets, 86

financing activities, 200

financing irrelevance principle, 20–21, 91–92

financing liabilities, 224n10

Fisher, Irving, 214n16

forward RNOA, 190

franchise, 121

free cash flows (FCF), 43–49, 63, 120, 124–25

free markets, 179

functional fixedness/functional fixation, 194

“fundamental betas,” 228n13

fundamentalists: modern finance principles and, 12–21; principles of, 5–12

future, bringing, forward in time, 47–48

future book value, 39–41, 52, 71, 140–41, 144

GAAP (Generally Accepted Accounting Principles). *See* Generally Accepted Accounting Principles (GAAP)

GDP growth rate, 73–77, 222n11

General Electric, 45, 47, 52–55, 57, 136–37

Generally Accepted Accounting Principles (GAAP), 47–48, 105–7, 166, 198–206

General Mills, 96–99

going-concern value, 176

Graham, Benjamin: on calculating value, 44–45; on fictitious gains, 170; on growth, 10, 46; on intrinsic value, 64–65, 221n1

no-growth benchmark and, 72; on true value and speculative value, 213n13; on valuation models, 128; on valuation through book values, 51

grant-date accounting, 235n10

Greenspan, Alan, 78

Grossman-Stiglitz paradox, 213n10

growth: accounting for, 70–71, 80–81, 104; adding speculation to book value and, 54–57; asset pricing and, 27; benchmarking, 72–80, 81; B/P and, 150–62; cash accounting and, 46; E/P and, 150–62; generated by accounting, 115–26; intelligent investing and, 209; from investment, 83–88; long-term investments and, 23; paying too much for, 10; pricing, 147–48, 162–65; profitability generated by accounting and, 105–14; risk and, 126–27; in valuation formulas, 229n15; value and, 148–52. *See also* abnormal earnings growth (AEG); earnings growth

growth case, 154

growth investing, 159–62

growth rate: growth investing and, 161–62; long-term, 46, 68–69; residual earnings and, 222n12; in valuation formulas, 229n15. *See also* implied growth rates

growth-return profiles, 135–36

hard balance sheet, 200, 205

Hayek, Friedrich von, 15

hedge funds, 179, 216n32

Heisenberg principle, 172

hidden reserves, 118–20, 205

historical cost accounting: conclusions on, 187–88; criticism

of, 206; deferred revenues and, 157; fair value accounting and, 168–69, 202; good accounting and, 196–97; misconceptions about, 179–86; overview of, 166–67; risk and, 177

Home Depot, 45, 47

IASB (International Accounting Standards Board). *See* International Accounting Standards Board (IASB)

IMF (International Monetary Fund), 174

impairments, 204–5

implied growth rates, 71–75, 221n4

income statement, 197, 202–6

information: in efficient market hypothesis, 16–17; ignoring, 149, 162; in modern finance, 32; uncertainty and, 8

initial public offering (IPO) bubbles, 23

intangible assets, 111, 179–81, 183

Intel, 170, 175

intelligent investing, 208–10

International Accounting Standards Board (IASB), 166–67, 194, 234n8, 235n10

International Monetary Fund (IMF), 174

intrinsic value, 34, 64–66, 146, 221n1

inventory write-downs, 105–10

investing/investment: accrual accounting and, 218n9; fundamentalist principles of, 5–12; as game, 65–66; growth from, 83–88; hidden reserves and, 118–19; intelligent, 208–10; for the long run, 21–23; valuation and, 1–3

investment growth, 115–18

iPhone, 107, 203

IPO (initial public offering) bubbles, 23

irrational markets, 212n7

judgment, 143–44

Keynes, John Maynard, 20, 212n7

Knight, Frank, 139–40

labeling, 33–34, 151, 163

last in, first out (LIFO) accounting, 225n2

last in, first out (LIFO) dipping, 119

last in, first out (LIFO) reserve, 119

Level 1 fair value accounting, 172

Level 2 fair value accounting, 172

Level 3 fair value accounting, 172

leverage: accounting for, 95–101; conclusions on, 102–3; fair value accounting and, 178; growth and profitability from, 88–95; growth and risk and, 27, 158–59, 162–63; growth from, 83–84; intelligent investing and, 209; residual earnings and, 224n5; risk and, 20–21; ROCE and RNOA and, 225n11; stock repurchases and growth, 101–2; weighted-average return formula and, 227n8

liabilities, 95–96, 176–77, 224n10

LIFO (last in, first out) accounting, 225n2

LIFO (last in, first out) dipping, 119

LIFO (last in, first out) reserve, 119

limits to arbitrage, 212n7

liquidation, of hidden reserves, 118–20

liquidity, 172, 214n19

long-term growth, anchoring on, 75–77

long-term investments, 21–23, 69–70

lower-of-cost-or-market rule, 225n1
 Lucas, Robert, 15

maintenance capital expenditures, 49–50

market price(s): benchmarking
 growth and, 72–80; challenging
 speculation in, 66–72; conclusions
 on, 80–81; fair value accounting
 and, 232n17; intelligent investing
 and, 209; introduction to, 64–66

market risk premium, 25–26, 33,
 129–30, 226n1

Markowitz, Harry, 19, 24

mark-to-market accounting, 172–75

Mauboussin, Michael J., 69

Microsoft Corporation, 170, 175,
 181–83, 203

Miller and Modigliani (M&M)
 proposition, 18–21, 38, 44, 51,
 215n25, 219n12

modern finance: models of, 5–8,
 31–33, 144; principles of, 12–21;
 products of, 21–31

modernist approach to risk, 138–40

mortgage crisis, 171–72, 202

multipliers, 113–15

negative residual earnings, 85–87,
 221n4

net financing expenses, 97

net operating assets, 96, 99, 101. *See also* return on net operating assets
 (RNOA)

Nikkei 225 index, 211n3

no-arbitrage principle, 13, 26, 28–30,
 34, 42

no-growth benchmark, 72

no-growth case, 108, 109, 154, 159–60

no-growth return, 136–37

no-growth valuation, 54–57, 182–83,
 210

normal distribution, 138–39,
 143

Ohlson, James, 236n15

Ohlson-Juettner abnormal earnings
 growth model, 59, 222n12

one-to-one principle, 174–77

operating activities, 200

operating assets, 95–96, 184–85. *See also* net operating assets; return
 on net operating assets (RNOA)

operating income, 99–101, 184–85

operating liabilities, 95–96, 224n10

Pandit, Vikram, 171

patience, 11

payout, value and, 38

P/B (price-to-book) ratio. *See* price-to-book (P/B) ratio

P/E (price-earnings) ratio. *See* price-earnings (P/E) ratio

Pfizer, 110–11

portfolio theory, 19–20

Preinreich, Gabriel, 218n11

price: comparable multiples and, 23;
 defined, 7; efficient market
 hypothesis and, 14–17; fair value
 accounting and, 169–73; one-to-one
 principle and, 174–76; risk
 measures and, 140; value and,
 10–11. *See also* asset pricing
 models; relative pricing

price-earnings (P/E) ratio, 57–61,
 93–95, 203–4

price-to-book (P/B) ratio, 26, 42, 57,
 93–95, 102, 153–54

Prince, Chuck, 212n7

probabilities, analysis of, 143–44

Procter & Gamble, 111, 113

profitability: generated by
 accounting, 105–14; generated by
 leverage, 88–95

profit determination, 203–5
pro forma numbers, 36–37

Q-score, 119–20
quant models, 144

R&D. *See* research and development
Rappaport, Alfred, 69
rate-of-return, 42–43, 52, 55–56, 110–12, 157. *See also* returns
receivables, 47–48, 201
relative pricing, 32
required return: capital asset pricing model and, 129–31; finessing cost-of-capital and, 131–38; introduction to, 128–29
research and development, 110–11, 119, 126, 155, 180–81, 236n14
residual earnings: change in, 58–59; for equity, 223n2; growth and, 55–57, 68–69, 222n12; leverage and, 224n5; negative, 85–87, 221n4
residual earnings growth, 84, 104, 115–18
residual earnings model, 51–52, 61, 218n11, 219n20
residual operating income, 99–101, 104, 184–85
restructuring charges, 204–5
return on assets (ROA), 224n10
return on net operating assets (RNOA), 97–101, 109–14, 190, 225n11
returns: in high and low portfolios, 229n1; historical, 190–94, 216n29; on value and growth investing, 159–62. *See also* rate-of-return
revenue recognition, 109, 195, 203, 234n7
revenues, on income statements, 203. *See also* deferred revenues

reverse-engineering growth forecasts, 210, 226n5
risk: accounting for, 128–29; accounting modeling of, 140–45; B/P and, 150–62; capital asset pricing model and, 129–31; conclusions on, 145–46; diversification and, 19–20, 24; E/P and, 149–62; fair value accounting and, 177–79; finessing cost-of-capital and, 131–38; growth and, 27, 126–27, 147–48; ignoring information on, 149; intelligent investing and, 208–9; long-term investments and, 22; modernist approach to, 138–40; of paying too much, 7–8; tolerance, 226n3, 227n7
risk premium. *See* market risk premium
risky growth benchmark, 77–80
RNOA (return on net operating assets). *See* return on net operating assets (RNOA)
ROCE. *See* book rate-of-return on common equity (ROCE)

S&P 500 growth benchmark, 72–75, 133–34
selling, general, and administrative expenses (SG&A) line item, 202–3
SG&A (selling, general, and administrative expenses) line item, 202–3
shareholders: serving, 196, 199–200; statistics on, 211n1
Shareholder Scorecard, 228n11
Sharpe, Bill, 24–25
short-term growth, anchoring on, 75–77
simplicity, 206–7

SIV (special investment vehicles), 200, 201

SPE (special purpose entities), 200

special investment vehicles (SIV), 200, 201

special purpose entities (SPE), 200

speculation: adding, to book value, 50–57; capital asset pricing model and, 129; fundamental principles on, 8–11; intelligent investing and, 209, 210; judgment and, 144–45; in market price, 66–72

S-score, 190

standardization, in accounting, 234nn7, 8

Starbucks, 121–26, 136–37, 141, 157–58

stocks: employee options, 199–200, 235n10; fundamental principles on, 6–7; for the long run, 21–23, 69–70; repurchases and growth, 101–2, 224n4, 225n13

“stocks-and-flows” equation, 39

subsidies, 215n25

tail outcomes, 142–43

“taking a big bath,” 205

thesaurus approach, 195

time, bringing future forward in, 47–48

total accruals, 218n9

transactions, focusing on, 201–2

transparency, 202–3

Twain, Mark, 215n22

Tyco International, 83–85, 88, 109

uncertainty: conservative accounting and, 156–57; handling, 32–33, 209; information and, 8; intrinsic value and, 65; in modernist approach to risk, 140–41

understanding, 8–9

unlevering accounting, 95–101, 210, 224n10

valuation: accounting and, 62; anchoring, 9–10; defined, 33; investing and, 1–3, 7; market prices and, 80

valuation models, 128, 163–64

Valuation Principle 1, 39–41, 164–65

Valuation Principle 2, 42–43, 157, 165

Valuation Principle 3, 52, 165

Valuation Principle 4, 84, 165

Valuation Principle 5a, 93–94, 165

Valuation Principle 5b, 94, 165

Valuation Principle 6, 113, 165

value: accounting for, 37–43, 62–63; asset pricing and, 27; borrowing and, 20–21; cash flows and, 17; comparable multiples and, 23; defined, 7, 10; dividend irrelevance and, 18–19; growth and, 148–52, 164; intelligent investing and, 208–9; intrinsic value, 64–65; leverage and, 20–21; long-term investments and, 23

Value at Risk (VaR), 142

value investing, 159–62

VaR (Value at Risk), 142

variable interest entities (VIE), 200

VIE (variable interest entities), 200

Volcker, Paul A., 167

The Wall Street Journal, 228n11

Wal-Mart, 45, 47

weighted-average return formula, 152–55, 210, 227n8

Weill, Sanford, 86

Williams, John Burr, 69, 214n16, 219n11

write-downs, 204–5

Yardeni, Edward, 223n14